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IN THE

Supreme Court of the United States

ELECTRONIC TRADING GROUP, LLC,
On behalf of itself and all others similarly situated,

Petitioner,

—v.—

BANC OF AMERICA SECURITIES LLC, BEAR STEARNS COMPANIES, INC., CITIGROUP INC., CREDIT SUISSE (USA) INC., DEUTSCHE BANK SECURITIES, INC., GOLDMAN SACHS & CO., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, MORGAN STANLEY & CO. INCORPORATED, UBS FINANCIAL SERVICES, INC., CIBC WORLD MARKETS CORP., CITIGROUP GLOBAL MARKETS, INC., CREDIT SUISSE SECURITIES (USA) LLC, GOLDMAN SACHS EXECUTION & CLEARING, L.P., MORGAN STANLEY DW INC., THE GOLDMAN SACHS GROUP, INC., and VAN DER MOOLEN SPECIALISTS USA, LLC,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does a Second Circuit decision immunizing Wall Street prime brokers from the antitrust laws materially conflict with this Court's recent holding in *Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S. 264 (2007)? The Second Circuit held that hypothetical future Securities and Exchange Commission ("SEC") regulations were in conflict with Section 1 of the Sherman Antitrust Act and thus created implied antitrust immunity—barring a private civil price-fixing complaint against Wall Street "prime brokerage" houses that conspired horizontally to fix fees they charged to customers. Although the SEC has never regulated such fees (for lending stock in connection with short sales), the Second Circuit held that the possibility that the SEC "may decide to regulate" them in the future gave rise to antitrust immunity.

2. Should a court of appeals, without statutory interpretation and without hearing the views of any of the agencies concerned, delineate jurisdictional boundaries between different federal agencies in the context of a private dispute? In contrast with *Billing*, neither the SEC nor federal antitrust enforcement authorities expressed any view below on the alleged conflict between their regulatory regimes. Nonetheless, the Second Circuit, finding that the SEC "may decide to regulate" in the future, barred any action under the antitrust laws in the area of short sales because of "implied immunity."

3. Can enforcement of the antitrust laws prohibiting price-fixing properly coexist with securities regulation in the arena of securities short selling?

CORPORATE DISCLOSURE STATEMENT

Petitioner Electronic Trading Group, LLC is a privately-held New York limited liability corporation, and no publicly held company owns ten percent or more of its stock.

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Electronic Trading Group, LLC, on behalf of itself and all others similarly situated, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The opinion of the court of appeals is reported at 588 F.3d 128 (2d Cir. 2009) and is reproduced in the Appendix at 1a-22a. The decision of the United States District Court for the Southern District of New York is reported at 527 F. Supp. 2d 253 (S.D.N.Y. 2007) and is reproduced in the Appendix at 23a-40a.

JURISDICTION

The judgment of the court of appeals was entered on December 3, 2009. Pet. App. 1a. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 1 of the Sherman Antitrust Act, 15 U.S.C. § 1, provides, in relevant part, that:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $100,000,000 if a corporation, or, if any other

> person, $1,000,000, or by imprisonment not exceeding 10 years, or by both said punishments, in the discretion of the court.

Section 4 of the Clayton Act, 15 U.S.C. § 15, provides, in relevant part, that:

> any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States in the district in which the defendant resides or is found or has an agent, without respect to the amount in controversy, and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee. . . .

Section 10(a)(1) of the Securities Exchange Act, 15 U.S.C. § 78j(a)(1), provides, in relevant part, that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . to effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 203(b)(1)(i-iii) of SEC Regulation SHO, 17 C.F.R. § 242.203(b)(1)(i)-(iii), provides, in relevant part, that:

> A broker or dealer may not accept a short sale order in an equity security from another per-

son, or effect a short sale in an equity security for its own account, unless the broker or dealer has: (i) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (iii) Documented compliance with this paragraph (b)(1).

STATEMENT

A private civil antitrust complaint[1] charged Wall Street "prime brokerage" firms and their affiliates with an elaborate price-fixing conspiracy to raise and fix the fees that those firms—horizontal competitors of each other—charged for lending "hard-to-borrow" stock to customers in connection with short sales.[2] The Second Circuit—without seeking or considering the views of the SEC or the Antitrust

[1] The complaint asserted claims under Sections 4 and 16 of the Clayton Act, 15 U.S.C. §§ 15 and 26, and under state law. Federal jurisdiction in the district court was based on 28 U.S.C. §§ 1331, 1337 and 1367(a).

[2] A short sale is a sale of securities that the seller does not own. It is, in effect, a bet that the market price of that stock will drop. When the system operates lawfully, the short seller's broker borrows the stock on behalf of the seller (*see* SEC Regulation SHO, *supra*), and delivers it to the purchaser's broker to close the trade. Meanwhile, the short seller commits to repay the stock loan in kind—usually with similar stock purchased on the open market at a later date. The short seller hopes that after his sale the market price will decline, allowing him at a later date to purchase replacement stock at a lower price to close out his loan and pocket the price difference. Brokers impose daily fees for lending stock, and those fees grow larger in relation to the scarcity of the stock. Lists of "hard-to-borrow" stock circulate within the brokerage community.

Division of the Justice Department—substantially misapplied this Court's decision in *Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S. 264 (2007) so as to affirm the dismissal of the complaint on a motion to dismiss, holding that the *Billing* doctrine of implied antitrust immunity precluded *any* application of the antitrust laws in the arena of securities short selling, regardless of the content of current securities law or regulation on the subject. The Second Circuit's principal rationale for finding the prime brokers' activities to be immune from antitrust scrutiny was that the SEC has colorable jurisdiction to regulate *all* short selling activity and *might* in the future choose to exercise that jurisdiction over the conduct in question. That holding is necessarily in conflict with the underlying rationale of *Billing*, and also raises profound federalism implications.

It is indisputable that the SEC has *not* regulated fees for stock borrowing in more than 75 years. Nor has the SEC ever legitimized the collusive conduct complained of. Nevertheless, the Second Circuit found that there were both actual and potential conflicts between Section 1 of the Sherman Antitrust Act and the SEC's regulatory regime because the SEC has the *theoretical* power to make future (unspecified) regulations governing short selling practices. Pet. App. at 18a-19a. In reaching this conclusion, the court of appeals' opinion did not further describe the purpose, nature or content of any such hypothetical regulations, nor did it venture a judgment as to how they might in fact conflict with the Sherman Act or its administration.

Neither the SEC nor the Department of Justice took any position on this case in either the district court or the court of appeals (and neither court

sought their views). No testimony was adduced with respect to the SEC's practices or intentions. Without knowing the position of either agency, and without a factual record, the Second Circuit effectively precluded all antitrust enforcement (private or governmental) with respect to price-fixing related to the short selling of securities.

Price-fixing among horizontal competitors constitutes a core *"per se"* violation of the antitrust laws (Section 1 of the Sherman Antitrust Act, 15 U.S.C. § 1—a criminal statute). Section 4 of the Clayton Act (15 U.S.C. § 15) provides an express private civil remedy for those "injured in [their] business or property" by such conduct. That private remedy was designed to supplement civil and criminal enforcement of the Sherman Act by the government. The defendants did not and could not argue in the lower courts that the securities laws or regulations (expressly or by implication) permitted prime brokerage firms to restrain trade by price-fixing the fees they charged to lend securities. The SEC has never condoned that type of conduct (nor, for that matter, do the securities laws or regulations cover it in any way).

Moreover, the securities laws plainly do not contain a private right of action—nor permit the SEC to create one—for price-fixing or any similar conduct in connection with stock loans.[3] The securities

[3] This Court has held that certain *anti-fraud* provisions of the securities laws imply private rights of action, but the conduct complained of here does not sound in fraud and therefore does not appear to violate those statutes or their implementing regulations. *See, e.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983) (implied civil remedy under Section 10(b) of the Securities Exchange Act is "beyond peradventure"); *Affiliated Ute Citizens v United States*, 406 U.S. 128, 150-54 (1972).

laws and rules do not regulate stock loan fees or contain any private enforcement device, akin to the private antitrust right of action under the Clayton Act, to remedy price-fixing in that arena.

Therefore, the Second Circuit's decision—if allowed to stand—would mean that civil plaintiffs who have been damaged by a horizontal price-fixing conspiracy that has anything to do with short selling could never obtain any redress at all under *either* the securities laws or the antitrust laws—and, ironically, not because the SEC has *in fact* regulated the activity in question or given any hint that it intends to, but because *some day, in some unspecified way, it might*. Governmental enforcement of the antitrust laws in any case having to do with the short selling of securities would be likewise precluded by the decision below.

Billing set out four factors for determining whether judicially implied antitrust immunity should exist with respect to activities within the securities arena: (a) is the activity in question within the "heartland" of securities regulation? (b) does the SEC have authority to regulate it? (c) is there active and ongoing SEC regulation in the area? and, (d) is there actual or implied conflict between the securities and antitrust regimes so as to "produce conflicting guidance, requirements, duties, privileges or standards of conduct"? *Billing*, 551 U.S. at 275-76, 285.

While purporting to construe *Billing*, the Second Circuit in fact substantially misapplied this Court's careful and conservative balancing of the interests involved. *Billing* limited implied immunity only to cases where there was a "'clear repugnancy'" between the securities and antitrust regimes, and

sought to harmonize the securities and antitrust regulatory regimes where possible. *Id.* at 275. Immunity will be implied only where the "specific conduct at issue" conflicts with the "regulatory program set forth in the [securities] statute[s]." *Id.* at 271. One touchstone is whether the "regulatory scheme . . . performs the antitrust function of insuring that rules that injure competition are nonetheless justified as furthering legitimate regulatory ends." *Id.* at 271-72 (internal quotations omitted). In *Billing*, although such injuries to competition were alleged, the SEC itself advocated for implied immunity in order to protect its "regulatory program." Not so here.

The court of appeals committed three principal errors. *First*, it interpreted the first three *Billing* factors too broadly, so as to include all short selling activities. Short selling, the court of appeals found, fell within (a) the supposed "heartland" of securities regulation and (b) the scope of the SEC's regulatory authority, and (c) was a subject of ongoing SEC regulation. Pet. App. at 11a-17a. In essence, the court of appeals found that the SEC had authority to, and did, regulate *somewhere* within the arena of short selling—and that this constituted an SEC "regulatory program" in conflict with antitrust law. In fact, *Billing* requires a far narrower depth of focus, so that the "*specific* conduct at issue" can be meaningfully measured against *specific* aspects of the "regulatory program." By taking too broad a view of the regulatory landscape, the Second Circuit effectively ignored both this Court's prescriptions and the content and purpose of the regulations applicable to short selling: the court of appeals simply did not examine the existing securities laws or SEC regulations to see if they

were related in any way to the "specific conduct at issue"—which they were not.

Second, the court of appeals declined entirely to focus on the (unregulated) pernicious nature and anticompetitive effect of the "specific [price-fixing] conduct at issue"—the injuries to competition about which, under *Billing*, the regulatory system needs to be concerned. The complaint described the price-fixing in question as a core violation of the Sherman Antitrust Act. But the court of appeals simply did not (and could not) determine whether hypothetical future SEC rules would take such injuries to competition into account and justify them as "furthering legitimate regulatory ends," as *Billing* requires. This resulted in a finding (with little or no factual support and no evidentiary record at all) that:

> An actual conflict [between the two regulatory regimes] arises because antitrust liability [for price-fixing] would inhibit [brokers] from engaging *in other* conduct that the SEC currently permits and that benefits the efficient functioning of the short selling market. There is potential conflict because the SEC *in the future* may decide to regulate the borrowing fees charged by brokers. (Emphasis supplied) Pet. App. at 18a-19a.

Third, the court of appeals delineated important jurisdictional boundaries with respect to the activities of federal regulatory agencies. It divested the antitrust authorities as well as private plaintiffs of any power to remediate price-fixing, a *per se* antitrust violation, in the entire short selling arena in deference to hypothetical future SEC regulation.

And it did so without obtaining or even seeking the views of the agencies involved.

REASONS FOR GRANTING THE PETITION

I. The Court Of Appeals' Decision Conflicts Materially With *Billing*

Recent events have made it all too clear that the public interest requires Wall Street to operate openly for the benefit of investors and those affected by the activities of large financial institutions. Applicable law should be enforced to prevent brokers from gaining clandestine profits as a result of criminally collusive activities. According to a century of antitrust jurisprudence in this country, price-fixing among horizontal competitors is a *per se* violation of the Sherman Act. It is always harmful to competition. It is never justified. *See, e.g., Northern Pacific Ry. Co. v. United States*, 356 U.S. 1, 5 (1958); *United States v. Trenton Potteries Co.*, 273 U.S. 392, 397-98 (1927). The antitrust laws vindicate this important public interest by providing criminal penalties and civil remedies for price-fixing. We respectfully submit this Court should grant certiorari to rectify the Second Circuit's radical misapplication of *Billing*, which—if left to stand, in the world's financial capital—would immunize such hard-core violations of antitrust law because of a purely hypothetical conflict with future (albeit highly unlikely and completely undefined) SEC regulations.

In *Billing*, the SEC made its views plain: that cooperative activities among underwriting syndicates in the heavily regulated arena of initial

public securities offerings should not be hampered by the potentially conflicting standards and duties imposed by certain aspects of antitrust law. The conduct that the plaintiffs challenged in *Billing* consisted primarily of "laddering" and "tying" arrangements which were not *per se* violations of the antitrust laws (as price-fixing is).[4] The SEC indicated that it *approved* much of that conduct, 551 U.S. at 276, and this Court held that it served a legitimate business purpose in connection with "joint underwriting activity . . . , including road shows and book-building efforts essential to the successful marketing of an IPO." *Id.* The underlying purpose of the *Billing* decision was, therefore, to support the primacy of the SEC's regulatory regime—which permitted such activities, under certain circumstances and with certain limits, in the interest of efficient capital market functioning.

Here, by contrast, the SEC has *not* taken a position in favor of price-fixing in the short selling arena (and it is inconceivable that it ever would). Further, the SEC has never shown any interest in

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[4] This Court once considered tying arrangements to be *per se* antitrust violations, creating liability regardless of the proof of market impact. More recent cases have overruled those precedents and required a detailed analysis of the market circumstances. *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28, 45 (2006) ("Many tying arrangements, even those involving patents and requirements ties, are fully consistent with a free, competitive market.") *Billing* was fully consistent with *Illinois Tool* and left it to the SEC to determine the market impact of tying and laddering arrangements, among other factors, in the context of its ongoing regulation of initial public offerings. The decision below is not consistent with that line of reasoning because the SEC neither has the expertise nor has expressed any desire to determine the market impact of fee price-fixing.

expanding its regulatory reach to cover the activities in question—even assuming a statutory foundation upon which it could do so. It would be ludicrous to suggest that price-fixing (unlike "laddering" or "tying") could ever have a positive impact on the functioning of securities markets generally or the "short selling market" in particular, as the Second Circuit held. Thus, the decision below does not serve any articulated congressional or regulatory policy whatsoever. The Second Circuit is the first federal court of appeals to interpret *Billing*, and—sitting as it does in the country's financial epicenter—its rulings in this area are likely to have pervasive nationwide influence. If this decision is allowed to stand, that influence will be extremely unfortunate.

II. The Writ Should Be Granted To Assure That Courts Of Appeals Obtain A Factual Record And Consider The Views Of Government Agencies Before Adjudicating The Boundaries Of Allegedly Conflicting Regulatory Activities

The court of appeals here limited the jurisdictional authority of one federal agency charged with the administration of justice (the Antitrust Division of the Department of Justice, whose activities are supplemented by private antitrust enforcement) in favor of the supposed regulatory authority of another (the SEC, which has never acted in the arena). The lower court did this without any sort of factual record and without seeking or considering the views of either of the agencies involved. In effect, the court of appeals prohibited the Antitrust Division and private plaintiffs from pursuing price-fixing misconduct connected with short selling in the securities markets, even though nothing in the

securities laws implies such a prohibition. As noted, neither affected federal agency had given the court the benefit of its own views on the matter (much less did the SEC indicate, as in *Billing*, that it actually approved certain of the conduct in question). That is a profoundly troubling precedent in the context of our federal system. This Court has the power to step in where lower courts have "so far departed from the accepted and usual course of judicial proceedings . . . as to call for an exercise of this Court's supervisory power." Supreme Court Rule 10(a); *cf., Hollingsworth v. Perry*, 130 S. Ct. 705, 713 (2010) ("This Court also has a significant interest in supervising the administration of the judicial system."). This case calls for such supervisory action to ensure that lower courts adjudicate jurisdictional boundaries among federal agencies with due regard for the views of those agencies and for the harmonization of the statutory schemes under which they operate.

Of course, courts routinely interpret statutes to define the limits of agency jurisdiction. However, that is not what happened below. The court of appeals did not arrive at its decision through statutory interpretation. It never considered the content or purpose of the antitrust laws at all. Contrary to the teaching of *Billing*, it did not parse the securities statutory framework nor consider the scope or objectives of the SEC's regulatory scheme *with respect to the conduct in question*. The Second Circuit contented itself with the conclusion that short selling was *in general* an activity that the SEC could and sometimes did regulate.

This Court often invites the Solicitor General to provide the views of the United States on whether

the writ should be granted. It is respectfully submitted that such an invitation is appropriate here.

III. The Writ Should Be Granted To Make It Clear That The Antitrust And Securities Regulatory Regimes Do Not Conflict In Cases Of This Kind

On the particular facts of this case, the court of appeals expressed a concern that legitimate behavior in the short selling arena (such as permissible communications between brokers in the course of attempting to locate stock that might be available for lending) could be inhibited if those brokers were concerned about the overhanging specter of potential antitrust liability. Pet. App. at 19a-20a. That fear is not well-founded (and, of course, the view of the court of appeals is pure speculation, not supported by any evidentiary record and uninformed by the views of either the antitrust enforcement authorities or the SEC). To the contrary, as the complaint makes clear, the prime brokerage firms' price-fixing—though not itself violative of the securities laws—actually enabled the defendants to engage in other *illegitimate* practices within the short-selling arena that the SEC was attempting (if unsuccessfully) to control through regulation.

The prime brokerage firms jointly controlled almost all of the market for stock lending. When they discovered that they could agree with each other to fix the fees for their loans of stock, they also discovered that they could often impose such fees on customers *without ever lending the stock*. According to the complaint, these brokerages made further collusive agreements with each other that they would reciprocally permit "failures to deliver"

supposedly borrowed stock in order to consummate trades. In those instances, *although no delivery of shares actually took place and the transactions occurred only on paper*, the sellers' brokers would collect "short sale" proceeds from buyers' brokers and deliver those proceeds to the sellers. When representing buyers, these firms would grant reciprocal treatment. Freed of the necessity to actually deliver stock in connection with short sales, brokers thus dealt in imaginary stock as if it were real—they collected transactional commissions and charged rigged "lending" fees to customers who were none the wiser.

The SEC has attempted to limit "failures to deliver" through regulation,[5] and may well engage in further regulation in that arena, but—as the Second Circuit acknowledged—this regulatory activity does "not focus on the regulation of borrowing fees (the particular conduct alleged to be anticompetitive)." Pet. App. at 17a. In other words, as the court of appeals recognized, the underlying conspiracy to fix "borrowing fees" has not itself been a subject of SEC enforcement even though that conspiracy created an environment in which these unwelcome delivery failures could flourish. (The complaint did not charge that "failures to deliver" were an *element* of the price-fixing conspiracy, but rather that they were a noxious

[5] In 2004 the SEC promulgated Regulation SHO governing short sales, pertinent excerpts of which are at pp. 2-3, above. Under that regulation, short sellers are, in general, required to borrow the stock that is the subject of their short sales. Regulation SHO has been amended several times to specify the circumstances under which "fail to deliver" positions would (and would not) be permitted to exist.

byproduct which permitted that conspiracy to have a far broader scope than it otherwise might have.) One reason why the writ should be granted in this case is to make it clear that the SEC regulation of "failures to deliver" and antitrust prohibitions of price-fixing can and should exist side by side and serve perfectly complementary objectives in the public interest—thus harmonizing the two regulatory regimes, as *Billing* counsels.

A well-reasoned point of view on this issue emerges from the District of Nevada in *In re Western States Wholesale Natural Gas Antitrust Litigation*, 661 F. Supp. 2d 1172 (D. Nev. 2009). That case involved wash trades and churning among gas pipeline companies, which amounted to a form of price-fixing. Although that conduct also violated the regulatory scheme under the Commodities Exchange Act ("CEA"), the district court did not perceive any "line-drawing" issues involving the coverage of the two statutes and therefore (properly applying the *Billing* test, 551 U.S. at 285) found no "risk that applying both the CEA and the antitrust laws would result in conflicting guidance, requirements, duties, privileges, or standards of conduct." *In re Western States*, 661 F. Supp. 2d at 1179. Judge Pro declined to grant implied immunity from the antitrust laws, noting that the charged antitrust violations clearly involved intentionally wrongful conduct. Quoting *Billing*, he observed that judges and juries are "not likely to make 'unusually serious mistakes' regarding intent, knowledge, purpose, or agreement, such that permissible or encouraged conduct under the CEA would be deterred." *Id.* at 1180.

Just so here. Legitimate conversations among brokers about whether and on what conditions stock is available for lending do not bear the slightest resemblance to deliberately conspiratorial communications to fix uniform lending fees for arbitrarily determined lists of supposedly "hard-to-borrow" stocks, and to charge those fees whether or not the stock is actually loaned. Judges and juries should have no difficulty in discerning the difference, nor should market participants.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Dated: March 3, 2010

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

August Term, 2009

(Argued: September 30, 2009
Decided: December 3, 2009)

Docket No. 08-0420-cv

ELECTRONIC TRADING GROUP, LLC, on behalf of itself and all others similarly situated,

Plaintiff-Appellant,

—v.—

BANC OF AMERICA SECURITIES LLC, BEAR STEARNS COMPANIES, INC., CITIGROUP INC., CREDIT SUISSE (USA) INC., DEUTSCHE BANK SECURITIES, INC., GOLDMAN, SACHS & CO., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, MORGAN STANLEY & CO. INCORPORATED, UBS FINANCIAL SERVICES, INC., CIBC WORLD MARKETS CORP., CITIGROUP GLOBAL MARKETS, INC., CREDIT SUISSE SECURITIES (USA) LLC, GOLDMAN SACHS EXECUTION & CLEARING, L.P., MORGAN STANLEY DW INC., THE GOLDMAN SACHS GROUP, INC., and VAN DER MOOLEN SPECIALISTS USA, LLC,

Defendants-Appellees,

JOHN DOES, DAIWA AMERICA CORPORATION, DAIWA SECURITIES AMERICA INC., BANK OF NEW YORK, J.P. MORGAN CHASE & CO., J.P. MORGAN SECURITIES INC., and LEHMAN BROTHERS INC.,

Defendants.

Before:

JACOBS, *Chief Judge*,
SACK and LYNCH, *Circuit Judges*.

Plaintiff-appellant Electronic Trading Group, LLC appeals from a judgment of the United States District Court for the Southern District of New York (Marrero, *J.*) dismissing a Sherman Act claim with prejudice and dismissing three state law claims without prejudice to refilling in state court. The district court evaluated the four considerations recently articulated by the United States Supreme Court in *Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S. 264 (2007), and found implied preclusion from antitrust liability. We affirm.

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DENNIS JACOBS, *Chief Judge*:

In this putative class action, plaintiff-appellant Electronic Trading Group, LLC ("ETG"), a short-seller, sues certain financial institutions that serve as "prime brokers" in short sale transactions.[1] It is alleged that the prime brokers arbitrarily designated certain securities as hard-to-borrow and then fixed the price for borrowing them, in violation of Section 1 of the Sherman Act, 15 U.S.C. § 1 (the "antitrust claim").[2] Three state law claims are also pleaded: breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and unjust enrichment (collectively, the "state law claims").[3]

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[1] The defendants-appellees are Banc of America Securities LLC; Bear Stearns Companies, Inc.; Citigroup Inc.; Credit Suisse (USA) Inc.; Deutsche Bank Securities, Inc.; Goldman, Sachs & Co.; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Morgan Stanley & Co., Incorporated; UBS Financial Services, Inc.; CIBC World Markets Corp.; Citigroup Global Markets, Inc.; Credit Suisse Securities (USA) LLC; Goldman Sachs Execution & Clearing, L.P.; The Goldman Sachs Group, Inc.; Van Der Moolen Specialists USA, LLC; and Morgan Stanley DW Inc.

[2] "A complaint pleading a violation of section 1 must allege a contract, combination or conspiracy that unreasonably restrains trade." *Elecs. Commc'ns Corp. v. Toshiba Am. Consumer Prods., Inc.*, 129 F.3d 240, 243 (2d Cir. 1997).

[3] ETG brought the breach of fiduciary duty claim against Morgan Stanley DW Inc.; Bear Stearns Companies, Inc.; Goldman Sachs Execution & Clearing, L.P.; Goldman, Sachs & Co.; UBS Financial Services, Inc.; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Citigroup Global Markets, Inc.; Credit Suisse Securities (USA) LLC; Deutsche Bank Securities, Inc.; Banc of America Securities LLC;

ETG appeals from a judgment of the United States District Court for the Southern District of New York (Marrero, *J.*), dismissing the antitrust claim with prejudice on the ground of implied preclusion of the antitrust law by the securities law, and dismissing the state law claims without prejudice to refilling in state court. We affirm.

The preclusion analysis turns on four considerations identified in *Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S. 264, 285 (2007): whether the "area of conduct [is] squarely within the heartland of securities regulations"; whether the Securities and Exchange Commission ("SEC") has "clear and adequate [] authority to regulate"; whether there is "active and ongoing agency regulation"; and whether "a serious conflict" arises between antitrust law and securities regulations.

Much depends on the level of particularity or generality at which each *Billing* consideration is evaluated. Obviously, if the inquiry is whether the SEC actively regulates the pricing of borrowed shares, the plaintiff wins the point. By the same token, if the inquiry is whether short selling is within the heartland of securities regulations, the defendants win the point.

For the reasons set forth in this opinion, the fourth consideration—detection of a serious conflict—is evaluated at the level of the alleged anti-

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Van Der Moolen Specialists USA, LLC; and CIBC World Markets Corp.

ETG brought the aiding and abetting breach of fiduciary duty claim against the parent corporations of some of the prime brokers named in the breach of fiduciary duty claim—Morgan Stanley & Co., Incorporated; The Goldman Sachs Group, Inc.; Citigroup Inc.; and Credit Suisse (USA) Inc.

competitive conduct. Each of the three remaining considerations is evaluated at the level most useful to the court in achieving the overarching goal of avoiding conflict between the securities and antitrust regimes.

BACKGROUND

A. Short Selling

A short sale transaction proceeds in the following sequence. The short seller identifies securities she believes will drop in market price, borrows these securities from a broker (prime brokers have the greatest market share), sells the borrowed securities on the open market, purchases replacement securities on the open market, and returns them to the broker—thereby closing the short seller's position. The short seller's profit (if any) is the difference between the market price at which she sold the borrowed securities and the market price at which she purchased the replacement securities, less borrowing fees, brokerage fees, interest, and any other charges levied by the broker.

B. The Role of the Prime Broker

In the context of short selling, a prime broker locates the short seller's requested securities, lends those securities to the short seller for a fee, and delivers those securities to the short seller's purchaser.

A short seller seeking to borrow securities contacts the broker's securities loan desk. Pursuant to SEC regulations, the securities loan desk must

locate the requested securities before it can accept the short seller's order. *See* 17 C.F.R. § 242.203(b)(1)(i)-(iii). The securities loan desk may locate the securities in its own proprietary accounts, or in the hands of other brokers or institutional investors with significant long positions. Alternatively, the securities loan desk may locate the securities through a third party who assists the broker in exchange for a locate fee.

The broker charges the short seller a borrowing fee affected by supply and demand: the harder the security is to find and borrow, the higher the fee. The broker may develop an easy-to-borrow list of securities that are in abundant supply and a hard-to-borrow list of securities that are scarce. *See* Short Sales, Exchange Act Release No. 34-50103, 83 SEC Docket 1278 (July 28, 2004).

A short seller who has sold the borrowed securities on the open market must delivery those securities to the purchaser within three days of the transaction date. If the short seller's broker does not deliver in time, a failure-to-deliver ("FTD") occurs.

C. The Borrowing Fees Conspiracy

It is alleged that from April 12, 2000 to the present, the prime brokers charged "artificially inflated" borrowing fees by agreeing on which securities to designate arbitrarily as hard-to-borrow, and setting minimum borrowing fees for these securities. (There are other allegations, set out in the margin, which we do not reach.[4])

[4] ETG's Amended Class Action Complaint (the "complaint") also alleges that the prime brokers (i) failed to enforce the delivery of securities, thereby enabling the prime

D. Procedural History

On March 15, 2007, the prime brokers moved to dismiss the antitrust claim pursuant to Federal Rules of Civil Procedure 12(b)(6) and 9(b). On June 18, 2007, the United States Supreme Court decided *Billing*. On December 20, 2007, the district court applied *Billing*, granted the prime brokers' motion to dismiss the antitrust claim under Rule 12(b)(6), and declined to exercise supplemental jurisdiction over the state law claims.[5] ETG timely appealed the district court's decision, arguing principally that the district court misapplied *Billing*.

DISCUSSION

"We review the district court's grant of a Rule 12(b)(6) motion *de novo*, drawing all reasonable

brokers to charge borrowing fees for securities that were never actually borrowed and giving rise to intentional FTDs; and (ii) charged improper locate fees when the securities were never found and/or borrowed. On appeal, ETG argues that the complaint's "references to failures to deliver" and "improper and unjustified locate fees" were "pleaded [only] as an adjunct to [ETG's] price-fixing claim." Appellant's Reply Br. 17 & 17 n.12. The prime brokers argue that ETG improperly seeks to amend the complaint on appeal by recharacterizing these allegations from integral components of the conspiracy to ancillary means of expanding the conspiracy's scope. Appellees' Opp'n Br. 24-25. We do not reach this issue, because dismissal remains appropriate even if we adopt ETG's appellate posture.

[5] The district court did not reach the alternative Rule 9(b) ground for dismissal of the antitrust claim. We do not reach this ground because we affirm the district court's Rule 12(b)(6) dismissal.

inferences in plaintiff['s] favor, and accepting as true all the factual allegations in the complaint." *In re Elevator Antitrust Litig.*, 502 F.3d 47, 50 (2d Cir. 2007) (*per curiam*) (internal quotation marks, citations, and brackets omitted).

Credit Suisse Securities (USA) LLC v. Billing, 551 U.S. 264 (2007), was an antitrust action against underwriting firms that marketed and distributed shares in initial public offerings ("IPO"). The plaintiffs alleged "that the underwriters unlawfully agreed with one another that they would not sell shares of a popular new issue to a buyer unless that buyer committed (1) to buy additional shares of that security later at escalating prices (a practice called 'laddering'), (2) to pay unusually high commissions on subsequent security purchases from the underwriters, or (3) to purchase from the underwriters other less desirable securities (a practice called 'tying')." *Id.* at 267.

The Supreme Court ruled that federal securities law implicitly precluded application of the antitrust law to the underwriters' alleged anticompetitive conduct. The Court articulated four considerations that bear upon whether "the securities laws are 'clearly incompatible' with the application of the antitrust laws" in a particular context: (A) location within the heartland of securities regulations; (B) SEC authority to regulate; (C) ongoing SEC regulation; and (D) conflict between the two regimes. *Id.* at 285. In selecting the level of particularity at which to address each consideration, we draw guidance from the specifics of the Supreme Court's analysis in *Billing*, without suggesting, however, that the level of particularity applied to each

consideration in this case is prescriptive in every context.

A. Heartland

To ascertain whether "the possible conflict" between securities law and antitrust law affects "practices that lie squarely within an area of financial market activity that the securities law seeks to regulate," the Supreme Court looked to the broad underlying market activity. *Billing*, 551 U.S. at 276. In deciding that the antitrust allegations "concern practices that lie at the very heart of the securities marketing enterprise," the Court considered "the activities in question," which were found to consist of "the underwriters' efforts jointly to promote and to sell newly issued securities." *Id.* Accordingly, the Court focused on whether "[t]he IPO process" (the underlying market activity in *Billing*) was within the heartland (and ruled that it was); it did not focus on the laddering and tying arrangements (the alleged anticompetitive conduct in *Billing*). *Id.* This analysis suggests that the first consideration is properly evaluated at the level of the underlying market activity.

Accordingly, in this case, we consider whether short selling is within the heartland of the securities business. The district court found that "the liquidity and pricing benefits created by the short sales place these transactions 'within the heartland' of federal securities regulation and are 'central to the proper functioning of well-regulated capital markets.'" *In re Short Sale Antitrust Litig.*, 527 F. Supp.2d 253, 259 (S.D.N.Y. 2007) (quoting *Billing*, 551 U.S. at 276). ETG itself recognizes that

"short selling is market activity regulated by the securities law." Appellant's Reply Br. 3.

Short selling—the underlying market activity in this case—is "an area of conduct squarely within the heartland of securities regulations." *Billing*, 551 U.S. at 285. The first consideration thus weighs in favor of implied preclusion.

B. Authority to Regulate

To ascertain "the existence of regulatory authority under the securities law to supervise the activities in question" in *Billing*, 551 U.S. at 275, the Supreme Court looked to the role of the underwriters in the IPO process as well as to the alleged laddering and tying arrangements, *see id.* at 276-77. The Court determined that "the law grants the SEC authority to supervise all of the activities here in question. Indeed, the SEC possesses considerable power to forbid, permit, encourage, discourage, tolerate, limit, and otherwise regulate virtually every aspect of the practices in which underwriters engage." *Id.* at 276. The Court thus gauged regulation of activity that is more particular than the IPO process (the underlying market activity) and more general than the laddering and tying arrangements (the alleged anticompetitive conduct).

In addition, the Court cited regulations that grant the SEC power to regulate "communications between underwriting participants and their customers, including those that occur during road shows," which suggests that the Court also gauged regulation of the specific alleged anticompetitive conduct. *Id.* at 277.

Accordingly, we consider the existence of SEC authority to regulate (i) the role of the prime

brokers in short selling, and (ii) the borrowing fees charged by prime brokers. We find such authority in Section 10(a), Section 6, and 15 U.S.C. §§ 78o(c)(2)(D) and 78j(b).

Section 10(a) of the Securities Exchange Act of 1934 provides that it is unlawful "[t]o effect a short sale . . . of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(a)(1). Citing legislative history, ETG argues that Section 10(a) was intended only to regulate the manipulation of share price through short selling. *See* Appellant's Br. 20-21. However, nothing in the wording of Section 10(a) so limits its reach; and the SEC has interpreted Section 10(a) as a grant of "plenary authority to regulate short sales of securities registered on a national securities exchange . . . ." Short Sales, Exchange Act Release No. 34-48709, 68 Fed. Reg. 62,972 (proposed Nov. 6, 2003). The SEC thus has the authority to regulate the role of the prime brokers in short selling, as well as the borrowing fees charged by the prime brokers, pursuant to Section 10(a).

Section 6 of the Securities Exchange Act of 1934 provides that the SEC may "permit a national securities exchange, by rule, to impose a schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members for effecting transactions" if such fees are "reasonable" and "do not impose any burden on competition not necessary or appropriate" to further the purposes of the securities law. 15 U.S.C. § 78f(e)(1)(B). ETG characterizes Section 6 as a grant of limited

authority to permit exchanges to deviate from "the general prohibition on fixed commission rates." Appellant's Br. 22. Even accepting this characterization, the SEC thus has indirect authority to regulate the rates (including the borrowing fees) charged by the prime brokers in short selling.

In *Billing*, the Supreme Court relied in part on 15 U.S.C. § 78o(c)(2)(D) and 78j(b) as evidence of the SEC's broad power to define and prevent fraudulent, deceptive, and manipulative conduct by brokers and dealers. 551 U.S. at 277. These provisions apply with equal force to the role of the prime brokers in short selling and the borrowing fees they charge.

This second *Billing* consideration—focused as it is on whether the SEC has authority to regulate the role of the prime brokers in short selling and the borrowing fees charged by the prime brokers—thus weighs in favor of implied preclusion, even though none of the provisions discussed above explicitly references the regulation of the borrowing fees.

C. Ongoing Regulation

To evaluate "evidence that the responsible regulatory entities exercise [their] authority," *Billing*, 551 U.S. at 275, the Supreme Court looked to the role of the underwriters in the IPO process, *See Id.* at 277. The court determined that "the SEC has continuously exercised its legal authority to regulate conduct of the general kind now at issue. It has defined in detail, for example, what underwriters may and may not do any say during their road shows." *Id.* The Court thus looked to activity more particular than the IPO process (the underlying

market activity) and more general than the laddering and tying arrangements (the alleged anti-competitive conduct).

In this case, we therefore consider whether there is ongoing SEC regulation of the role of the prime brokers. Ample evidence reveals that the SEC exercises its authority to regulate the role of the prime brokers in short selling. "[A]ctive and ongoing agency regulation" is evidenced by Regulation SHO and a recent SEC roundtable. *Id.* at 285.

Regulation SHO, adopted by the SEC in 2004, imposes a "locate" requirement on brokers involved in short selling. *See* 17 C.F.R. § 242.203(b)(1)(i)-(iii) ("A broker or dealer may not accept a short sale order in an equity security from another person . . . unless the broker or dealer has: (i) [b]orrowed the security, or entered into a bona-fide arrangement to borrow the security; or (ii) [r]easonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. . . ."). Regulation SHO also imposes a "delivery" requirement on such brokers. *See* 17 C.F.R. § 242.203(b)(3) (with certain enumerated exceptions, "[i]f a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for thirteen consecutive settlement days, the participant shall immediately thereafter close out the fail to deliver position by purchasing securities of like kind and quantity"). Regulation SHO thus constitutes an exercise of the SEC's authority to supervise the role of the prime brokers in short selling.

On September 29-30, 2009 (at the time of oral argument in this appeal), the SEC hosted a

roundtable "regarding securities lending and short sales." Securities Lending and Short Sale Roundtable, Exchange Act Release No. 34-60643, 2009 WL 2915632, at *1 (Sept. 10, 2009) (announcing the roundtable). The roundtable intended to focus on "a range of securities lending topics, such as current lending practices and participants, compensation arrangements and conflicts, the benefits and risks of securities lending, risks related to cash collateral reinvestment, improvements to transparency, and consideration of whether the securities lending regulatory regime can be improved for the benefit of investors." *Id.* The roundtable also intended to focus on "short sale disclosure topics" and addressed "the potential impact of imposing a pre-borrow or enhanced 'locate' requirement on short sellers . . . as a way to curtail abusive 'naked' short selling." *Id.* This roundtable indicates active SEC monitoring of the role of the prime brokers in short selling.

ETG's complaint implicitly confirms active regulation. The complaint affirmatively alleges, presumably to flesh out claims of wrongdoing, that certain prime brokers "have been fined for not borrowing securities or failing to enter into agreements to borrow securities that are sold in short sale transactions and/or having reasonable grounds to believe that the securities could be borrowed so that they could be delivered on the delivery due date," Compl. ¶ 91, and that "federal prosecutors and the [New York Stock Exchange] have launched a joint investigation into [certain prime brokers'] alleged price gouging . . . by artificially inflating borrowing fees and by charging fees for which no

services were rendered," *id.* ¶ 92. A fair inference from the allegations is that the SEC and securities self-regulating organizations actively exercise regulatory authority over the role of the prime brokers in short selling.

Regulation SHO and the recent roundtable do not focus on the regulation of borrowing fees (the particular conduct alleged to be anticompetitive); but it is enough for this purpose that the SEC's ongoing regulation is focused on the role of the prime brokers in short selling. The third consideration thus weighs in favor of implied preclusion.

D. Conflict

To ascertain the "risk that the securities and antitrust laws, if both applicable, would produce conflicting guidance, requirements, duties, privileges, or standards of conduct," *Billing*, 551 U.S. at 275-76, the Supreme Court considered whether allowing antitrust liability for the conduct alleged to have the anticompetitive effect would inhibit permissible (and even beneficial) market behavior. *See id.* at 282 ("And the threat of antitrust mistakes, *i.e.*, results that stray outside the narrow bounds that plaintiffs seek to set, means that underwriters must act in ways that will avoid not simply conduct that the securities law forbids (and will likely continue to forbid), but also a wide range of joint conduct that the securities law permits or encourages (but which they fear could lead to an antitrust lawsuit and the risk of treble damages)."). In evaluating conflict, therefore, the proper focus is on the alleged anticompetitive conduct:

> [W]e do not read the complaints as attacking the bare existence of IPO underwriting syndicates or any of the joint activity that the SEC considers a necessary component of the IPO-related syndicate activity. . . . Nor do we understand the complaints as questioning underwriter agreements to fix the levels of their commissions, whether or not the resulting price is "excessive." We . . . read the complaints as attacking the manner in which the underwriters jointly seek to collect "excessive" commissions. The complaints attack underwriter efforts to collect commissions through certain practices (*i.e.*, laddering, tying, collecting excessive commissions in the form of later sales of the issued shares) . . . .

Id. at 278 (citations omitted).

In this case, therefore, we consider the impact that antitrust liability may have on arrangements for borrowing fees. ETG argues (i) that "there should be little difficulty in distinguishing collusive fee-fixing agreements from routine communications concerning stock availability and market pricing permissible under Regulation SHO"; and (ii) that "there is no actual or potential conflict that necessitates immunity" because neither the securities law nor the antitrust law permit the collusive fixing of borrowing fees. Appellant's Br. 32-33. The district court found otherwise. *See In re Short Sale Antitrust Litig.*, 527 F. Supp. 2d at 260.

We conclude that antitrust liability would create actual and potential conflicts with the securities regime. An actual conflict arises because antitrust

liability would inhibit the prime brokers (and other brokers) from engaging in other conduct that the SEC currently permits and that benefits the efficient functioning of the short selling market. There is a potential conflict because the SEC in the future may decide to regulate the borrowing fees charged by brokers.

1. Actual Conflict

Antitrust liability would inhibit conduct that the SEC permits and that assists the efficient functioning of the short selling market. The thrust of the ETG's case is that the prime brokers communicated with one another to designate hard-to-borrow securities and to fix inflated borrowing fees for those securities. However, it is permissible for brokers to communicate about the availability and price of securities. As the district court observed, "such exchanges are implicitly permitted by the SEC's Regulation SHO." *In re Short Sale Antitrust Litig.*, 527 F. Supp. 2d at 260 (citing 17 C.F.R. § 242.203(b)(1) (requiring that a broker borrow the securities or have reasonable grounds to believe that the securities can be borrowed before accepting an order from a short seller)). It is a lot to expect a broker "to distinguish what is forbidden from what is allowed," so that the broker collects just so much information as required to satisfy the locate requirement and for the efficient functioning of the short selling market—but not an iota more—or suffer treble damages. *Billing*, 551 U.S. at 280.

Conflict is a risk unless there is a "practical way to confine antitrust suits so that they challenge only activity of the kind the [plaintiffs] seek to target" without inhibiting other conduct that is

permitted or encouraged under the securities law. *Id.* at 282. The drawing of such intricate lines demands "securities-related expertise." *Id.* Moreover, it is likely that the very communications in which short sellers do what the securities law allows would by "reasonable but contradictory inferences" serve as evidence of conduct forbidden by the antitrust law. *Id.* Reliance on a jury therefore gives rise to a serious "risk of inconsistent court results." *Id.*

Antitrust liability, with the prospect of treble damages, would be an incentive for the prime brokers to curb their permissible exchange of information and thereby harm the efficient functioning of the short selling market. This inhibiting effect weighs in favor of implied preclusion.

2. Potential Conflict

In addition to the actual conflict described above, a potential conflict exists based on the possibility that the SEC will act upon its authority to regulate the borrowing fees set by prime brokers. As the Supreme Court acknowledged in *Billing*, a potential conflict of this kind may exist even if there is no conflict that is actual and immediate. *See Billing*, 551 U.S. at 273 (describing the "upshot" of *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659, 690-91 (1975), as "in light of potential future conflict, the Court found that the securities law precluded antitrust liability even in respect to a practice that both antitrust law and securities law might forbid"). In the context of an implied repeal case, this Court observed that "the proper focus is not on the Commission's current regulatory position but rather on the Commission's authority to permit

conduct that the antitrust laws would prohibit." *In re Stock Exchs. Options Trading Antitrust Litig.*, 317 F. 3D 134, 149 (2d Cir. 2003).

It is therefore not decisive that neither securities law nor antitrust law allows—or encourages—the collusive fixing of borrowing fees. The present securities regime expressly allows prime brokers to rely on easy-to-borrow lists as reasonable grounds "to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities." Short Sales, Exchange Act Release No. 34-50103, 83 SEC Docket 1278 (July 28, 2004). The SEC has taken note that the hard-to-borrow lists "are not widely used by broker-dealers" and that, therefore, "the fact that a security is not on a hard to borrow list cannot satisfy the 'reasonable grounds' test" described above. *Id.* But if and when such hard-to-borrow lists come into broader use, it is easy to see how they could increase the efficiency of the short selling market, in which event the SEC could move quickly to regulate the borrowing fees charged by brokers for securities appearing on such lists. This potential conflict weighs in favor of implied preclusion.

CONCLUSION

All four *Billing* considerations weigh in favor of implied preclusion.[6] We therefore affirm the district court's Rule 12(b)(6) dismissal of ETG's antitrust claim with prejudice. Moreover, we affirm the dismissal of ETG's state law claims without prejudice because we find no abuse of discretion in the district court's decision to decline to exercise supplemental jurisdiction over these claims. *See Kolari v. N.Y. Presbyterian Hosp.*, 455 F. 3d 118, 122 (2d Cir. 2006).

[6] Because all four of the *Billing* considerations point in the direction of implied preclusion, we need not address the weight to be accorded these considerations when they point in different directions.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re SHORT SALE ANTITRUST LITIGATION
06 Civ. 2859 (VM)

DECISION AND ORDER

VICTOR MARRERO, United States District Judge.

Plaintiff Electronic Trading Group L.L.C. ("ETG"), on behalf of itself and persons or entities similarly situated (collectively, "Class Members"), filed an Amended Class Action Complaint dated January 5, 2007 (the "Amended Complaint") against defendants Morgan Stanley & Co., Inc.; Morgan Stanley DW Inc. ("MSDW"); Bear Stearns Companies, Inc. ("Bear Stearns"); The Goldman Sachs Group, Inc.; Goldman Sachs & Co. ("GSC"); Goldman Sachs Execution & Clearing, L.P. ("GSEC"); UBS Financial Services, Inc. ("UBS"); Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"); Citigroup Inc.; Citigroup Global Markets, Inc. ("CGM"); Credit Suisse (USA) Inc.; Credit Suisse Securities (USA) L.L.C. ("CSS"); Deutsche Bank Securities, Inc. ("Deutsche Bank"); Lehman Brothers, Inc. ("Lehman"); Banc of America Securities L.L.C. ("Banc of America"); Van der Moolen Specialists USA, L.L.C. ("Van der Moolen"); CIBC World Markets Corp. ("CIBC") (collectively, "Defendants"). ETG alleges that Defendants

violated antitrust law, aided and abetted breach of fiduciary duty and were unjustly enriched, and that defendants MSDW, Bear Stearns, GSEC, GSC, UBS, Merrill Lynch, CGM, CSS, Deutsche Bank, Lehman, Banc of America, Van der Moolen, and CIBC (collectively, "Fiduciary Defendants") breached their fiduciary duties, in connection with certain short sale security transactions.

Defendants moved to dismiss the Amended Complaint pursuant to Federal Rules of Civil Procedure 12(b) (6) ("Rule 12 (b) (6)") and 9 (b) ("Rule 9 (b)"). For the reasons stated below, Defendants' motion is GRANTED.

I. BACKGROUND

The following facts are taken from the Amended Complaint, which the Court accepts as true for the purpose of ruling on the motion to dismiss. *See Chambers v. Time Warner, Inc.*, 282 F.3d 147, 152 (2d Cir. 2002) (*citing Gregory v. Daly*, 243 F.3d 687, 691 (2d Cir. 2001)).

A. *Operation of the Short Sale Securities Market*

Class Members have acted as short sellers ("Short Sellers") in short sale security transactions. In the short sale transactions at issue in this case, the Short Seller typically contacts its brokerage firm ("Seller's Broker") (*e.g.*, one of the Defendants), requesting that Seller's Broker lend particular securities ("Object Securities") to Short Seller. Short Seller then sells the Object Securities on the open market (to a "Purchaser") with the expectation that the Object Securities' market price will decline in the future. Later, Short Seller

purchases like securities on the open market and transfers them to Seller's Broker, replacing the Object Securities it borrowed earlier and closing its position. If Short Seller was correct and the Object Securities' price declined, Short Seller profits from the difference between the price received from selling the Object Securities and the price paid when replacing like securities, less any fees and interest charged by Seller's Broker.

Before Short Seller can effect a short sale transaction, it must submit a borrowing request to the Seller's Broker securities loan desk (the "Loan Desk"), and pursuant to SEC regulations, the Loan Desk is required to locate the securities available for borrowing. The Loan Desk may locate the Object Securities directly or through a finder, who operates as a third party intermediary assisting Seller's Broker by locating available Object Securities. If Seller's Broker uses a finder, Seller's Broker will typically charge short sellers "finders" or "locate" fees. If the Loan Desk locates the security directly, it may borrow the securities from its proprietary accounts, other brokerage firms (*e.g.*, another one of the Defendants), or (3) pension funds and institutional investors with significant long positions. Prior to Seller's Broker granting approval to execute the transaction, the Loan Desk must locate the Object Securities available for borrowing and inform Short Seller of the borrowing cost.

Until Short Seller replaces the borrowed securities, Short Seller pays Seller's Broker a daily borrowing fee. Absent the alleged conspiracy as described by the Class Members, each respective broker determines the amount of its borrowing fees

and which securities are designated as "hard-to-borrow" (such securities that Defendants classified and presented to Class Members as hard-to-borrow are the "Class Securities"). When a broker designates a security as hard-to-borrow, it generally charges a higher borrowing fee.

Once the Loan Desk obtains the Object Securities, Short Seller can then effect electronic delivery through the purchaser's brokerage firm ("Purchaser's Broker"). Purchaser's Broker, like Seller's Broker, is also oftentimes one of the Defendants because Defendants collectively control virtually all of the securities lending market. If Seller's Broker does not deliver the securities to Purchaser's Broker by the settlement date, a failure-to-deliver occurs ("FTD").

B. *Effect of Defendants' Alleged Conspiracy on Class Members' Short Sale Transactions*

ETG claims that from April 12, 2000, to the present, Class Members paid artificially inflated and unjustified fees to Defendants in connection with the borrowing and purported borrowing of Class Securities. ETG contends that Defendants entered into a combination, conspiracy, and agreement, through illegal price fixing and other wrongful conduct, to charge Class Members artificially inflated borrowing fees in connection with the borrowing of Class Securities, in violation of Section 1 of the Sherman Act, 15 U.S.C. § 1 (the "Antitrust Claim"). ETG claims that, to achieve the alleged conspiracy's objective, Defendants engaged in daily communications via telephone, e-mail, and/or facsimile to agree on which securities to classify as hard-to-borrow and to fix the minimum borrowing

rates for Class Securities. ETG alleges that Defendants charged Class Members improper fees for purportedly locating securities, when in many instances, Defendants failed to locate and/or borrow the securities.

ETG also claims that since brokers are not required to report the identities of Purchasers or Short Sellers to regulators and because two of the Defendants generally act as Seller's Broker and Purchaser's Broker, Defendants conspired not to enforce delivery of shorted securities, allowing persistent FTDs. ETG claims that instead of forcing delivery, Defendants maintain running IOU tallies among themselves with the Seller's Broker debiting Short Seller's account and Purchaser's Broker crediting Purchaser's account so as to make it appear as though the securities were delivered. Accordingly, a given Short Seller and Purchaser will not know whether the securities they sold and purchased were ever borrowed or delivered.

II. DISCUSSION

A. *Standard of Review*

In considering a motion to dismiss pursuant to Rule 12(b)(6), a court construes the complaint broadly, "accepting all factual allegations in the complaint as true, and drawing all reasonable inferences in the plaintiff's favor." *Chambers v. Time Warner, Inc.*, 282 F.3d 147, 152 (2d Cir. 2002). However, mere "conclusions of law or unwarranted deductions of fact" need not be accepted as true. *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 771 (2d Cir. 1994) (citation and

quotation marks omitted). A court should not dismiss a complaint for failure to state a claim if the factual allegations sufficiently "raise a right to relief above the speculative level." *Bell Atl. Corp. v. Twombly*, 127 S. Ct. 1955, 1965 (2007).

B. *ETG's Antitrust Claim*

ETG's Antitrust Claim alleges that Defendants' conduct constituted a combination and conspiracy in restraint of trade, violating Section 1 of the Sherman Act, 15 U.S.C. § 1. Defendants, relying on the Supreme Court's recent decision in *Credit Suisse Secs. (USA) LLC v. Billing*, 127 S. Ct. 2383 (2007) ("*Billing*"), argue that the securities laws implicitly preclude application of the antitrust laws to the conduct alleged in the Amended Complaint.

1. *Credit Suisse Secs. (USA) LLC v. Billing*

In *Billing*, a group of securities buyers ("Buyers") filed an antitrust lawsuit against underwriting firms ("Underwriters") that market and distribute newly-issued securities ("IPOs"). Buyers claimed that Underwriters unlawfully conspired to not sell shares of popular IPOs to Buyers unless Buyers agreed to purchase additional shares at escalating prices, pay Underwriters unusually high commissions on subsequent security purchases, and/or purchase other less desirable securities from Underwriters (collectively, the "Conduct at Issue"), in violation of Section 1 of the Sherman Act, Section 2(c) of the Clayton Act, and state antitrust laws. Underwriters moved to dismiss Buyers' antitrust claims, arguing that the federal securities laws implicitly precluded application of the antitrust laws to the Conduct at Issue.

The Supreme Court stated that, where regulatory statutes are silent regarding preclusion of antitrust laws, the "courts must determine whether, and in what respects, [the regulatory statutes] implicitly preclude application of the antitrust laws." *Id.* at 2389. The securities laws implicitly preclude application of the antitrust laws, given the context and likely consequences, when the two are "clearly incompatible." *Id.* at 2392. The Court cited four critical factors (collectively, the "Factors") for determining within a given context whether securities laws and antitrust laws are clearly incompatible: (1) "the possible conflict affected practices that lie squarely within an area of financial market activity that the securities law[s] seek[ ] to regulate" (the "First Factor"); (2) "the existence of regulatory authority under the securities law to supervise the activities in question" (the "Second Factor"); (3) "evidence that the responsible regulatory entities exercise that authority" (the "Third Factor"); and (4) "a resulting risk that the securities and antitrust laws, if both applicable, would produce conflicting guidance, requirements, duties, privileges, or standards of conduct" (the "Fourth Factor"). *Id.*

After applying the Factors, the *Billing* Court concluded that the federal securities laws implicitly precluded application of the antitrust laws to the Conduct at Issue. Under the First Factor, the Court found that Underwriters' efforts to promote and sell IPOs were "central to the proper functioning of a well-regulated capital market" and "lie at the very heart of the securities marketing enterprise." *Id.* at 2392. Under the Second Factor, the Court found that the securities laws granted the United States

Securities and Exchange Commission (the "SEC") authority to supervise the Conduct at Issue, including the power to "forbid, permit, encourage, discourage, tolerate, limit, and otherwise regulate virtually every aspect of the practices in which underwriters engage." *Id.* at 2392-93 (*citing* 15 U.S.C. §§ 77b (a) (3), 77j, 77z-2, 78o(c) (2) (D), 78i (a) (6), and 78j (b)). Under the Third Factor, the Court found that the SEC has continuously exercised its authority to regulate the IPO transaction process, such as regulating IPO communications and bringing actions against underwriters who violate IPO regulations.

The Fourth Factor was the pivotal consideration before the Court. Buyers argued that there could be no conflict between the securities and antitrust laws because they both "aim to prohibit the same undesirable activity." *Id.* at 2393-94. The Court expressly accepted as true the Buyers' premise that the SEC has disapproved of—and will continue to disapprove of—the Conduct at Issue. The Court found that, even after accepting these pro-Buyer premises as true, there was a serious conflict between the securities laws and antitrust laws because: (1) there was a fine line separating the activity that the SEC permits (for which Buyers must concede antitrust immunity) from the activity that the SEC forbids (which, under Buyers' argument, should be open to antitrust claims), and the securities experts are in the best position to determine on what side of the line Underwriters' conduct falls; (2) "the need for securities-related expertise"; (3) "the overlapping evidence from which reasonable but contradictory inferences may be drawn"; and (4) the risk of inconsistent court results in

factually similar circumstances. *Id.* at 2394-96. The Court stated that in the IPO context, "there [was] no practical way to confine antitrust suits so that they challenge only . . . activity that is presently unlawful and will likely remain unlawful under the securities law[s]." *Id.* at 2395. Rather, the Court stated that "antitrust courts are likely to make unusually serious mistakes," and the threat of such mistakes may cause Underwriters to act in ways that will avoid "a wide range of joint conduct that the securities law[s] permit[ ] or encourage[ ] (but which [Underwriters] fear could lead to an antitrust lawsuit and the risk of treble damages)." *Id.* at 2395-96.

After determining that the Factors were satisfied, the Court concluded that, within the IPO context at issue, the securities laws were clearly incompatible with the application of the antitrust laws.

2. *Application of Billing to the Amended Complaint*

The Court finds that, within the short sale context at issue, the antitrust laws are clearly incompatible with the securities laws.

a. *An Area of Conduct Squarely Within the Heartland of Securities Regulations*

The short sale securities market lies squarely within an area of financial market activity that the securities laws seek to regulate. Short selling provides the securities markets with market liquidity and pricing efficiency. *See* 68 Fed. Reg. 62,972, 62,974 (Nov. 6, 2003). Short selling provides

market liquidity because it may offset temporary imbalances in the buying and selling interest for securities, which may reduce the risk that the price paid on the open market is artificially high due to temporary contractions of selling interest. *See id.* Short Sellers increase stock pricing efficiency because their transactions inform the market of the short sellers' evaluations of future stock price performance (*i.e.*, by engaging in short sales, Short Sellers inform the market that they believe particular securities are overvalued), and this evaluation is reflected in the particular securities' resulting market price. *See id.* at n. 21. The Court finds that the liquidity and pricing benefits created by the short sales place these transactions "within the heartland" of federal securities regulation and are "central to the proper functioning of well-regulated capital markets." *Billing*, 127 S. Ct. at 2392.

b. *Clear and Adequate SEC Authority to Regulate*

Under the securities laws, the SEC has regulatory authority to supervise short sale transactions. It is unlawful "[t]o effect a short sale . . . of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Securities Exchange Act of 1934 § 10(a), 15 U.S.C. § 78j (a) (1) ("Section 10(a)"). Section 10(a) grants the SEC "plenary authority to regulate short sales of securities registered on a national securities exchange . . .

as necessary to protect investors." 68 Fed. Reg. 62,972, 62,973 (Nov. 6, 2003).

The SEC may permit a national securities exchange to impose a schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by broker-dealers for effecting transactions, provided that the fees set are reasonable and do not impose any burden on competition not necessary or appropriate to further the purposes of the securities laws. *See* 15 U.S.C. § 78f(e)(1)(B). Congress has authorized the SEC to oversee the national securities clearance and settlement system. *See id.* at § 78q(d)(1). Thus, similar to the context in *Billing*, "the SEC possesses considerable power to forbid, permit, encourage, discourage, tolerate, limit, and otherwise regulate virtually every aspect" of the short sale securities market. *Billing*, 125 S. Ct. at 2392.

c. *Active and Ongoing Agency Regulation*

The Court notes that the regulatory agencies have exercised their authority to supervise short sale transactions. The SEC adopted Regulation SHO to regulate aspects of short sale transactions, such as determining prerequisites for effecting short sale transactions and defining broker-dealers' delivery obligations. *See* 17 C.F.R. § 242.203(b) (2007); *see also* Division of Market Regulation: Key Points About Regulation SHO (April 11, 2005), *available at* http://www.sec.gov/spotlight/keyregshoissues.htm (last visited Dec. 19, 2007) (stating that "Regulation SHO was adopted to update short sale regulation in light of numerous market developments since short sale regulation was first adopted in 1938"). The SEC has monitored

Regulation SHO's effects, amending it where appropriate. *See* SEC Release No. 34-55970 (removing price tests and restrictions on short sale execution prices to provide a more consistent regulatory environment). The National Association of Securities Dealers ("NASD") and New York Stock Exchange have also actively enforced their short sale regulations. *See, e.g., In re Dep't of Mkt. Regulation v. Ko Secs., Inc.*, No. CMS000142, 2004 WL 2983057, at *8-10 (N.A.S.D.R. Dec. 20, 2004) (affirming sanctions imposed for violations of NASD short sale rules because the member did not make an affirmative determination that it would receive delivery of the shorted securities by the settlement date); *In re Helfant Group, Inc.*, Exchange Hearing Panel Decision 04-3 (Jan. 13, 2004) (finding that a member violated Exchange Rule 440C, which requires members to maintain written evidence of affirmative determinations of stock availability prior to effecting short sale transactions).

By regulating short sale transactions, the SEC and other securities regulators have "exercised [their] legal authority to regulate conduct of the general kind at issue." *Billing*, 125 S. Ct. at 2393.

d. *Serious Conflict Between the Antitrust and Securities Laws*

The securities laws are in serious conflict with the antitrust laws within the short sale context at issue. After *Billing*, the serious conflict question now before this Court is, assuming that the SEC disapproves of (and will continue to disapprove of) the conduct at issue, whether "allow[ing] an antitrust lawsuit would threaten serious harm to

the efficient functioning of the securities market." *Id.* at 2394-96.

ETG's claim that Defendants conspired to classify particular securities as hard-to-borrow and to fix minimum borrowing rates, in this Court's application of *Billing*'s Fourth Factor, poses a serious legal line-drawing problem. A fine and complex line exists separating conduct that the SEC permits or encourages, which would foreclose antitrust liability, from activity that the SEC must forbid, which would allow for antitrust liability. ETG argues that daily communications regarding short sale transactions among Defendants crossed the line from communications permitted by the SEC to those outlawed by the antitrust laws. In order for one of the Defendants to effectuate a trade on a Short Seller's behalf, that defendant generally contacts another brokerage firm (likely another one of the Defendants) to locate and borrow the securities. The Defendants' transactions necessarily involve the exchange of information regarding the availability and price of securities, and such exchanges are implicitly permitted by the SEC's Regulation SHO. *See* 17 C.F.R. § 242.203(b) (1) (2007) (requiring that, prior to accepting a short sale order, the broker-dealer borrow the security, enter into an arrangement to borrow the security, or have reasonable grounds to believe that the security can be borrowed).

There is clear overlap in the short sale context between "evidence tending to show unlawful antitrust activity and evidence tending to show lawful securities [conduct]." *Billing*, 125 S. Ct. at 2395. Allowing ETG's antitrust suit to continue would deter Defendants from engaging in conduct

lawful under the SEC's regulatory scheme, because, in support of its conspiracy claim at a trial, ETG would likely seek to introduce evidence of Defendants' daily, permissible conversations regarding particular securities' trading information. The threat of a "nonexpert jury" mistaking lawful conduct under the securities laws as evidence of a conspiracy under the antitrust laws and exacerbated by the prospect of trebled damages, would place immense pressure on Defendants to curtail the open exchange of information. Such antitrust suits would likely chill a broad range of activities that the securities laws permit and encourage, and would likely inhibit the short selling activity that provides market liquidity and pricing efficiency.

ETG's claim that Defendants' alleged conspiracy included Seller's Broker tolerating FTDs without forcing Purchaser's Broker to actually deliver the securities, is also in serious conflict with the securities laws. Under Regulation SHO, only an FTD involving a "threshold security"[1] violates the securities laws. *See generally* 17 C.F.R. § 242.203 (2007). In the Amended Complaint, ETG defined the Class Securities as any security that Defendants classified and presented to ETG and Class Members as "hard-to-borrow," and accordingly, the Class Securities may include non-threshold securities. The SEC has elected not to require broker dealers that fail to receive a non-threshold security to "buy-in" the other party to the transaction. *See*

[1] Under Regulation SHO, the term "threshold security" means "any equity security of an issuer that is registered pursuant to [15 U.S.C. § 781] or for which the issuer is required to file reports pursuant to [15 U.S.C. § 78o(d)]." 17 C.F.R. § 242.203 (c) (6) (2007).

Division of Market Regulation: Responses to Frequently Asked Questions Regarding Regulation SHO, Question 7.3 (July 6, 2007), *available at* http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm (last visited Dec. 19, 2007) (stating that the SEC has declined to allow the National Clearing Corporation to require that brokers force buy-ins because forcing buy-ins may increase the risk in clearing and settling transactions and may interfere with the pricing of securities). Allowing ETG to use the antitrust laws to attack Defendants' alleged decisions not to force buy-ins would impose *de facto* delivery requirements in spite of the SEC's reluctance to impose such blanket requirements.

For the reasons stated above, the Court is persuaded that there is clear incompatibility between the securities laws and antitrust laws within the short sale context before the Court. Accordingly, the Court grants Defendants' Rule 12(b)(6) motion to dismiss the Antitrust Claim. Because the Court grants Defendants' Rule 12(b)(6) motion, there is no need for the Court to address Defendants' motion to dismiss pursuant to Rule 9(b).

C. *ETG's State Law Claims*

ETG also alleges state law claims for common law breach of fiduciary duty (against Fiduciary Defendants only), common law aiding and abetting breach of fiduciary duty, and common law unjust enrichment (collectively, the "State Law Claims"). ETG submits that this Court has supplemental jurisdiction over these state law claims pursuant to 28 U.S.C. § 1367(a) ("Section 1367(a)").

Federal courts "may examine subject matter jurisdiction, *sua sponte*, at any stage of the

proceeding." *Adams v. Suozzi*, 433 F.3d 220, 224 (2d Cir. 2005) (citation and quotation marks omitted). Federal district courts have supplemental jurisdiction over state-law claims that are "so related" to the claims over which the court has original jurisdiction that they form part of the same "case or controversy under Article III of the United States Constitution." 28 U.S.C. § 1367(a). A District court may "decline to exercise supplemental jurisdiction" if it "has dismissed all claims over which it has original jurisdiction." *Id.* at § 1367(c)(3). After a court's discretion to exercise supplemental jurisdiction is triggered under § 1367(c)(3), the court is to "balance [ ] the traditional 'values of judicial economy, convenience, fairness, and comity' in deciding whether to extend jurisdiction." *Kolari v. New York-Presbyterian Hosp.*, 455 F.3d 118, 122 (2d Cir. 2006) (*quoting Carnegie-Mellon Univ. v. Cohill*, 484 U.S. 343, 350 (1988)). "[I]n the usual case in which all federal-law claims are eliminated before trial, the balance of factors . . . will point toward declining to exercise jurisdiction over the remaining state-law claims." *Cohill*, 484 U.S. at 350 n. 7; *see also United Mine Workers v. Gibbs*, 383 U.S. 715, 726 (1966) ("[I]f the federal law claims are dismissed before trial . . . the state claims should be dismissed as well.").

The Court has original jurisdiction over ETG's federal Antitrust Claim pursuant to 28 U.S.C. §§ 1331 and 1337. ETG's State Law Claims rely on supplemental jurisdiction pursuant to Section 1367(a). Because the Court has granted Defendants' motion to dismiss ETG's Antitrust Claim, there is no longer a claim over which the Court has original jurisdiction. ETG's federal-law claim was

"eliminated on a motion to dismiss, prior to the investment of significant judicial resources." *Kolari*, 455 F.3d at 123. By permitting the claims to be re-filed in state court, ETG's State Law Claims "will be afforded a 'surer-footed reading of applicable law.'" *Id.* at 123-24 (*quoting Gibbs*, 383 U.S. at 726). After considering the values of judicial economy, convenience, fairness, and comity, the Court grants Defendants' motion to dismiss the State Law Claims without prejudice.

III. ORDER

For the reasons stated above, it is hereby

ORDERED that the motion (Docket No. 74) of defendants Morgan Stanley & Co., Inc.; Morgan Stanley DW Inc. ("MSDW"); Bear Stearns Companies, Inc. ("Bear Stearns"); The Goldman Sachs Group, Inc.; Goldman Sachs & Co. ("GSC"); Goldman Sachs Execution & Clearing, L.P. ("GSEC"); UBS Financial Services, Inc. ("UBS"); Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"); Citigroup Inc.; Citigroup Global Markets, Inc. ("CGM"); Credit Suisse (USA) Inc.; Credit Suisse Securities (USA) L.L.C. ("CSS"); Deutsche Bank Securities, Inc. ("Deutsche Bank"); Lehman Brothers, Inc. ("Lehman"); Banc of America Securities L.L.C. ("Banc of America"); Van der Moolen Specialists USA, L.L.C. ("Van der Moolen"); and CIBC World Markets Corp. ("CIBC") (collectively, "Defendants") to dismiss the claim of plaintiff Electronic Trading Group L.L.C.'s ("ETG") pursuant to Section 1 of the Sherman Act, 15 U.S.C. § 1, is **GRANTED** with prejudice; and it is further

ORDERED that the claims of ETG for aiding and abetting breach of fiduciary duty and unjust enrichment are dismissed as against Defendants without prejudice; and it is finally

ORDERED that the claim of ETG for breach of fiduciary duty as against MSDW, Bear Stearns, GSEC, GSC, UBS, Merrill Lynch, CGM, CSS, Deutsche Bank, Lehman, Banc of America, Van der Moolen, and CIBC is dismissed without prejudice.

The Clerk of Court is directed to close this case.

SO ORDERED.

Dated: New York, New York
20 December 2007

/s/ VICTOR MARRERO
VICTOR MARRERO
U.S.D.J.